

Looking Back, Looking Forward

It has been almost six months since the domestic market (based on the Wilshire Total Market Index) peaked. The sub-prime mortgage crisis and the foreclosure crisis have dominated the headlines as both hit Main Street and Wall Street. People everywhere are concerned about what the future will bring.

From the beginning of November, 2007 to the low of March 10th, 2008, the S&P 500 was down 16% and so was the Dow Jones Wilshire 5000 Total Market Index. The MSCI EAFE (international developed markets) index was down 18.85%, while the Emerging Markets Index was down 21.82% (source: finance.google.com.) That was really painful. [Note: From 3/18 to 4/2 they are up 8-15%]

On a morning when the markets were up around the world, I received several calls asking "Do you think we've hit bottom?" The S&P 500 was up almost 7% from its low of a couple of weeks ago, so I'm not sure what "bottom" people are asking about. About the same time of the market lows in March, the 3-month Treasury was yielding .59% (due to the run to safety), and it is now up to 1.39% (source:

Bloomberg.com). Some money is feeling a bit more comfortable taking risk, but that does not necessarily portend a trend.

There are still many unknowns out there. Recently someone said the problem with the various mortgage and asset backed securities was the lack of "knowing" the problems. He said it was like having ten bottles of water on the table in front of you and knowing that there is poison in one. You just don't know *which one*, so you simply don't drink any. Right now the problem is not so much with the known unknowns (risks), but with the unknown unknowns. There is no way to plan for the real unknowable events/risks.

Looking forward my advice is, as it has consistently been, to assure current needs and maintain broad diversification. With the sharp ups and downs of the past several months (the DJIA was own 360 points on 11/7 and up 420 points on 3/18. Source: finance.google.com), it has been problematic picking any direction. Diversification dampens volatility, but does not eliminate it. Keeping discipline within a plan is prudent and appropriate for long-term investments.

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The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general. NASDAQ Composite NASDAQ Composite Index - measures all NASDAQ domestic and international based common type stocks listed on The NASDAQ Stock Market. The MSCI EAFE® Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure developed market equity performance, excluding the US & Canada. The MSCI Emerging Markets IndexSM is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. Hang Seng Index - Consists of 33 stocks listed on the Hong Kong Stock Exchange, and it includes companies intended to represent four major market sectors: commerce and industry, finance, properties and utilities. The Dow Jones Wilshire 5000 Total Market Index represents the broadest index for the U.S. equity market, measuring the performance of all U.S. equity securities with readily available price data. The Dow Jones Industrial Average (DJIA) is a popular indicator of the stock market based on the average closing prices of 30 active U.S. stocks representative of the overall economy.

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Wealth Architecture™ Digest

Often people do not plan because they see only what is, and they do not have a vision of what can be. Something is always possible. We believe that, with vision, the possibilities are almost unlimited.

The Bare Facts of Bear and the Bear

If the reality of the sub-prime and credit crises were not enough to distract most people from other news, the spectacular collapse of one of the world's largest investment banks, Bear Stearns, certainly captured the front pages. A bit of information regarding Bear Stearns, and the mortgage crisis it had a part in creating, is instructive.

Bear Stearns (BSC) was founded in 1923 and became one of the principal players in the world of international finance. It had become a leader in the area of mortgage finance and secure-ization, as well as in dealing with hedge funds in all areas of buying, selling, and clearing stock, bond, and derivatives transactions. Its highly respected business gave it a place at the table in global finance.

At the end of November, 2007 BSC had assets of over \$35 billion in cash and total assets of \$395 billion (Source for these and following figures: finance.google.com). Almost \$264 billion of these assets were long term investments that included the various kinds of mortgage-backed securities that have dropped significantly in value. Looking further down the financial statement, one notes that BSC also had \$383 billion in total debt, much of which appears to be secured by the assets – including the ones that have been dropping in value. At the bottom line, BSC had only \$11.8 billion in equity (assets minus liabilities). A drop of just 4% in the long term investments would wipe out all of the equity. Recently BSC's leverage became 31 to 1, and confidence gave way

to concern, then to resignation and finally abandonment.

On March 11th the popular TV financial "guru," Jim Cramer (*Mad Money* on CNBC,) was asked by a viewer "Should I be worried about Bear Stearns in terms of liquidity and get my money out?" Cramer, in a very impassioned response (typical on his program) answered, "NO, NO, NO...Bear Stearns is fine. DO NOT take your money out.... Bear Stearns is not in trouble." (source: CNBC.com). He followed up on Monday telling people to sell the financial stocks. I hope they didn't act in haste. From March 18th to April 23rd, Lehman Bros. was up 38% , while the battered Countrywide was up 36%.

From the time the markets peaked on 10/31/07, the S&P 500 is down 9.9%, while the NASDAQ Composite is down over 14.69%. The broad international index (the EAFE) is off over 11%, and the Hang Seng index is off 20.4% over the same period. There were no equity markets where one could hide from the bear, but when any "good news" happens, they have moved in a positive direction. (source for prices: finance.google.com)

As I always say, I have no idea what *will* happen, but the one thing that has proven reliable to moderate volatility is to maintain diversification. This is to give you a flavor of what has been happening, not to give any advice as to what to do. I am always available to discuss individual needs or concerns.

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The Three-Legged Stool

Life can be a balancing act. The more legs a stool has, the more stable it is, even if one breaks. Asset management is more like a three-legged stool, with each leg being very important, albeit for different reasons. The three legs are asset allocation, asset management, and taxes.

In 1986 the seminal study of determinates of portfolio performance was published (Gary P. Brinson, L. Randolph Hood, and Gilbert L. Beebower, "Determinants of Portfolio Performance," *Financial Analysts Journal*, July-August 1986, pp. 39-44). Its basic conclusions were that asset allocation accounted for over 90% of portfolio performance over time. Thirteen years later another analysis concluded, "manager selection matters, but not to any great extent." (Surz, Stevens & Wimer "Investment Policy Explains All," *The Journal of Performance Management* Summer 1999, pgs. 43-46). The data indicate that the decisions we make on asset allocation, which are also used to manage risk, are paramount.

The second leg of the stool, asset management, while statistically less important, is still essential to portfolio construction. There are managers who employ tactical techniques to attempt to reduce risk or

Over Time

Part of the difficulty in talking with clients about how to deal with increased volatility and uncertainty is that all portfolio optimization is based on probabilities that are expected to be accurate *over time*. While it is generally accepted that results are less predictable over short periods than long ones, there is little specificity as to any particular result at any given time. History teaches us that the longer the period studied, the more closely the results followed the expected returns.

I can look back over eighty years of data and determine that over that period there have been a number of statistical realities: stocks were more volatile than bonds; stocks had a higher return than bonds; small stocks were riskier than large stocks and provided higher returns. The language of statistics

enhance returns. This could be true with tactical allocation, sector rotation, etc. This would be a form of active management, and while it may add risk-adjusted value, it does increase tax and transaction costs based on the turnover in the portfolio. Passive management, by its very design, has low turnover.

That brings us to the last leg of the stool: taxes. Actively managed portfolios will generally have higher turnover, with tactical portfolios having the highest. If a portfolio turns over more than once a year, gains will be short term in nature. Just because of the timing of gains and losses, you could have a year where you've lost money, but you still have short-term taxable gains. This can create a bit of a mismatch between taxable income and portfolio values.

While none of what I have referenced can itself be used to determine the best portfolio design, it is important to understand that all legs of the stool -- all aspects of portfolio design -- must be considered. There is a great deal more to prudent investment management than simply evaluating managers and their past performance.

(which looks back) is remarkably precise, but when applied to future events, the language of probability is filled with increasing uncertainty, especially as time periods shrink.

So, when I suggest that over time we can expect a given range of results, I know that neither a specific time nor a specific result is definitive. This is problematic primarily because people prefer certainty and want to believe that someone knows what is happening and what *will* happen. The reality is that certainty is not possible when it comes to predicting markets. Remember, certainty means being 100% sure that X will happen. If there is *any* possibility that it will not happen as or when predicted, then it is, by definition **not** certain.

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We all live in the present, with memories of the past, and a desire to feel we have some handle on our future. As individuals we are uncomfortable when we watch losses in portfolios and don't feel we know when things will improve. "Over time," while the only realistic approach to portfolio expectations, is of little comfort to the emotional discomfort associated with dropping values.

As a professional advisor who is responsible for creating and maintaining prudent portfolios, I need to be up front with clients and manage expectations. I present the facts and opinions as I understand them, realizing that some decisions will be right, and some wrong, especially in the short term. Every person's needs, goals, and risk tolerance are different. The precise choices for portfolios and withdrawal patterns need to be carefully and periodically revisited within an overall strategic plan that has a higher probability of success *over time*.

Expectations and the Weather Report

A current weather report is instructive about here and now. Most of us have learned that when we try to plan ahead based on a ten-day forecast, the weatherman may not be accurate, and we would never trust a weather forecast for three years and two weeks from today in planning a trip. However, when a stock weatherman, called an analyst, predicts the future price of a stock – or the market as a whole – we may *expect* that since he or she is an expert, we can venture out knowing there will be clear skies for our investment. That would be a mistake.

Decision making -- whether it be in what to invest, how to draft wills, or when to go on vacation – requires setting expectations. The difficulty is accepting that random events happen and upset the best plans, be they personal, business, or investment. You cannot avoid the unknown, but you can be prepared to accept detours and set alternate routes that have a reasonable chance of getting you where you need to be, even if a bit late.

Academics and investment professionals use terms like *expected return*, which are based on very sophisticated mathematic models. But these are models of probable outcomes, built on historical data, combined with adjustments for how the professional thinks the markets will behave in the future. This is called probability versus statistics. They can say that

“assuming (and that is an important modifier) certain levels of return and volatility, you can expect the following...” There is no certainty, just proforma results with the caveat that “past performance is not a guarantee of future results.”

Recent turmoil in the financial markets has uncovered a new issue. In modelling the expected returns as described above, the analysis includes calculations for randomness. I would refer to this as the known unknown. When something previously unthought of crops up, we have an "unknown unknown." There is really no way to model a variable that you don't know exists.

Lack of certainty does not keep me from creating prudent, diversified investment plans designed to meet clients' goals. I recognize, and share with all clients, the reality of volatility and do whatever I can to manage this risk. This brief article is meant to stress that I also need to manage expectations so that there is constant awareness of what to expect – including the unexpected. No one cares if they are surprised on the upside, but neither life nor investments are that simple. If you've ever left home to go somewhere that normally takes 30 minutes, but you run into gridlock due to a bad accident and were delayed for an hour, you know what I mean.